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"A Sophisticated Point"

The failure of socialism does not mean that bureaucrats have lost their thirst for power.

"[L]ook at the price system as ...a mechanism for communicating information," wrote F.A. Hayek over 50 years ago.[1] Since then, the superiority of the price system to the dictats of central planning as a means of "communicating information" has become manifest. This was because, among other things (in Hayek's words), "The most significant fact about [the price] system is the economy of knowledge with which it operates, or how little the individual participants need to know in order to be able to take the right action... only the most essential information is passed on, and passed on only to those concerned."

In the same essay, Hayek stated that:

> It is in many ways fortunate that the dispute about the indispensability of the price system for any rational calculation in a complex society is no longer conducted entirely between camps holding different political views. The thesis that without the price system we could not preserve a society based on such extensive division of labor as ours was greeted with a howl of derision when it was first advanced by Von Mises twenty five years ago [in 1920-Ed.]. Today, the difficulties which some still find in accepting it are no longer mainly political, and this makes for an atmosphere much more conducive to reasonable discussion. When we find Leon Trotsky arguing that "economic accounting is unthinkable without market relations"; when Professor Oscar Lange promises Professor von Mises a statue in the marble halls of the future Central Planning Board; when Professor Abba P. Lerner rediscovers Adam Smith and emphasizes that the essential utility of the price system consists in inducing the individual, while seeking his own interest, to do what is in the general interest, the differences can indeed be no longer ascribed to political prejudice. The remaining dissent seems clearly to be due to purely intellectual, and more particularly methodological, differences.

Socialist theoreticians never managed to integrate price signals with central planning. The reason was not only that the information transmitted to and from the planners was generally specious (falsified by managers, politically motivated, etc.) and tardy, but also, and more importantly, because the quotas and orders of a command economy cannot provide consistent incentives "to move in the right direction," i.e., to economize on resources, to "those concerned."

Of course, the widespread recognition of the "indispensable" role of the price system in coordinating economic activity Hayek noted among the strategists of socialism over two generations ago has taken a very long time to filter down to its foot soldiers. Nevertheless, after long and bitter experience with command economies, we now seldom hear about seizing control of the means of production or preaching about surplus value, historical inevitability or any of the other secular revelations of Karl Marx. Today, those who continue to favor an allocation of resources via subsidies, taxes, bureaucratic controls, or some combination of the three usually speak of correcting specific "market failures" rather than of changing the entire system.

"Market Failure"

The identification and correction of "market failure" often is simply the substitution of the tastes and values of the interventionists for those of market participants (restrictive zoning and building codes, for example). More generally, *any* perceived "problem" may be labeled a "market failure" so that an interventionist "solution" may be applied. This usually is done with little or no regard for inconvenient questions (such as whether or not the market process has been disrupted by prior interventions or whether the market has anything to do with the issue at hand).

A recent example of this was in the area of health care. The perceived problems were 1) that the costs of health care have grown very rapidly and 2) that many individuals are not covered by private health insurance, Medicare, or Medicaid. These mainly reflect interventions in health care market that have resulted in increasing payments for treatment by third parties (insurance, Medicare, and Medicaid) rather than patients.

The specific interventions included the exemption of employer-paid health insurance premiums from the employees' taxable incomes as well as the government subsidies of Medicare and outlays for Medicaid. These reduced, or even eliminated, the requirement for patients and providers to weigh medical costs against other wants and needs. The fact that treatment is "free" or nearly so for the patient, no doubt causes more treatment to be requested and provided. It should also be noted, however, that spending on medical care would probably have grown even without third party payment. Given the aging of the population and the development of new medical procedures, consumers would probably have increased their outlays even if medical care had remained on a strictly fee-for-service basis.

These interventions have also made health insurance more expensive for those not covered by employer or government insurance. This is not only because individually-purchased health insurance must be purchased with after-tax income but also because its purchase is optional. More chronically sick people are included in the self-selected pool of individuals who purchase health insurance themselves than there are in either the population as a whole or in employer-paid health plans (employed persons tend to be healthier than the general population).

The Clinton administration addressed these with an astoundingly bureaucratic "solution" (one that was quickly rejected by the Congress and the voters), which did little to address the existing government interventions that were the main

[1] F.A. Hayek, "The Use of Knowledge in Society," *The American Economic Review*, Vol. XXXV, No. 4, September 1945, p. 519.

cause of the problems. Our point here is not to analyze the health care issue, but to note the continuing bias toward interventionist solutions rather than on finding ways to let the market work.

Methodology

When Professor Hayek wrote of "methodological" differences being all that remained of disputes over the efficacy of the price system, he referred to the question of whether all of the pertinent information could be "known to a single mind." This was what the socialist theoreticians mistakenly assumed. But as Hayek concluded, "Any approach, such as that of much of mathematical economics with its simultaneous equations, which in effect starts from the assumption that people's *knowledge* corresponds with the objective facts of the situation, leaves out what is our main task to explain."

This notion (that volumes of minute information on economic decisions can be centrally analyzed -- made available "to a single mind") remains embedded in the economics profession, even as analyses and understanding of prices are ignored or deemed somehow disreputable.

As a small example, we will consider the issue of bank "racism" in mortgage lending. The alleged problem is that Afro-Americans are less likely to be homeowners than the rest of the population. One reason for this might be discrimination by mortgage lenders; indeed, a 1991 analysis of 6.6 million mortgage applications by the Federal Reserve Board, showed that 37.6 percent of applications from Afro-Americans were turned down vs. 17.3 percent of applications from whites. This study was widely criticized because it did not consider many of the factors typically involved in the application process such as the applicants' ages, net worths, or employment and credit histories.

Alicia Munnell of the Boston Federal Reserve then conducted another study, using Boston-area mortgage applications, that "corrected" for standard credit criteria. This study indicated that such criteria only "explained" about two-thirds of the discrepancy between blacks and whites and concluded that the remainder was due to racial discrimination. This effort was immediately hailed as "definitive" and prompted calls for additional stringent regulation of banking practices.

The essential flaw in this approach is the notion that anything as closely linked to individual and local circumstances as the decision to make a mortgage loan can be usefully examined from abstracted, before-the-fact, information. The discrepancies could reflect something so simple as marginal applicants making more applications. Whites who are turned down may be in a better position to improve their chances on re-application (say by coming up with a larger down payment) than blacks. Marketing efforts to the Afro-American community may generate more applications from marginal applicants. And so on and so forth.

These studies ignore the very purpose of the mortgage application process – to limit defaults on the mortgage loans actually granted. If the rate of default of a bank's mortgage loan portfolio (which is the "price" of making mortgage loans instead of purchasing, say, Treasury bonds) is too high, then the bank should be doing something else with its depositors' money. Dr. Munnell (she holds a Harvard Ph.D. in economics) told a reporter from *Forbes* magazine: "We were aware that people say 'this may be rational discrimination, because minorities default more.'"[2] She also stated that her sample of applications was too recent to examine for defaults but that the Boston Fed had examined defaults in census tracts, and that "...there was no relation between the racial composition of the tract and the default rate. So it wasn't true that tracts with large minority populations had higher default rates."

"A Sophisticated Point"

There are many reason why census tracts may not be the best way to examine default rates. Nevertheless, Dr. Munnell's apparent belief that if "minority" *borrowers* do not default more than others, then rejection of their *applications* at higher rate must reflect discrimination, is incredible. She has it reversed. In fact, only if the default rate (to repeat, this is the price banks pay for making mortgage loans) was the same for all races could the lenders be said to be free from racism in lending. When the *Forbes* reporter brought this up, she called it "a sophisticated point."

The most revealing aspect of this was that the Fed's vast efforts were not directed toward examining default rates in the first place. If such studies did reveal excessively stringent credit standards for Afro-Americans, i.e., lower default rates, the findings could then have been publicized as an overlooked profit opportunity for lenders, rather than used as a pretext for more controls. That is not, alas, how bureaucrats think.❑

[2] Forbes, Feb. 4, 1993, p. 48.

WISHFUL THINKING ON THE BUDGET

The notion of balancing the budget within 7 years is an appealing one, but future Congresses will not be bound by budget projections made this year, and such projections are likely to be wrong anyway. Moreover, none of the plans that have been discussed addresses the longer-term need for sweeping reform of the entitlement programs that now dominate the budget.

We have two depressing observations about the effort by Republicans to get President Clinton to agree to a plan to balance the Federal budget over the next 7 years. One, none of the proposed budget plans would result in a balanced budget by 2002. Two, balancing the budget by 2002 is the easy part compared to the real political challenge, which will be to balance the budget and limit the growth of government *after* 2002, when Federal outlays and the burden of financing them are expected to increase rapidly to a level unprecedented in peacetime.

The various proposals to balance the budget over the next 7 years will fail to do so because they do not (and cannot) lock in outlays beyond 1996. Roughly a third of the $1.5 trillion that the Government will spend this year is so-called discretionary spending, *i.e.*, spending that requires Congress to enact and the President to sign annual appropriations bills. Discretionary spending currently is covered by 13 appropriations bills, and it was the failure of Congress and the President to agree on some of these bills (or on a continuing resolution to provide temporary funding) that led to the recent shutdowns of parts of the Federal government. All these bills authorize spending only for fiscal (FY) 1996, which began last October. Before FY 1997 begins next October, Congress will have to pass and the President will have to sign another batch of bills authorizing funding for that year. Likewise in FY 1998 through 2002.

Thus, the annual appropriations for these programs will be decided in future years by whoever is in Congress and the White House a year from now, and two years, and in 2002. These politicians will not be bound by a budget plan agreed on in 1996. Such a plan might serve as a road map, at best.

However, history has not been kind to

such guidelines. Previous Congresses have abandoned or "revised" multi-year budget plans when their requirements became too politically painful to follow (remember the Gramm-Rudman-Hollings plan that "mandated" a balanced budget by 1991?).

Forecasting Interest Rates in the Year 2002

Another difficulty with any long-term budget plan is that the economic and demographic assumptions underlying its outlay, revenue, and deficit projections are almost certain to be wrong. Policymakers are no better at predicting, say, how high interest rates will be next year (let alone in 2002) than are "professional" economic forecasters. Thus, their budget forecasts are little more than guesses.

To take a recent example, at the start of FY 1994 Clinton's Office of Management and Budget (OMB) projected that the budget deficit for the year would be $258 billion. This forecast turned out to be *$55 billion* too high. One factor in this large error was that interest rates were lower than forecasters anticipated, therefore outlays for interest payments on the national debt were lower than expected. More recently, the $193 deficit projection made by the OMB last February, when fiscal 1995 was a third over, was $29 million too high.

They are even worse at predicting economic recessions. We have not seen the economic projections built into the various budget proposals being discussed, but it would be remarkable if any of them allowed for the possibility of recession. Yet it is highly likely that the U.S. economy will experience a business contraction sometime during the next 7 years; otherwise, it would have to expand for 11 consecutive years (1991 through 2002), which is 2 years more than the longest expansion in U.S. history. Recessions wreak havoc on budget forecasts. In 1990, a recession year, the Bush Administration forecast that the deficit for the year would be $124 billion. The recorded deficit was $221 billion, or 78 percent larger than predicted.

All this is not to suggest that the budget cannot be balanced by 2002, only that it is impossible for Congress and the White House to do so by agreeing in 1996 on a multi-year package of spending and revenue projections. The projections would be too uncertain and the agreement would be too vulnerable to revision. Achieving and maintaining a balanced budget cannot be done with one stroke of a pen, but will have to be accomplished one year at a time, year after year.

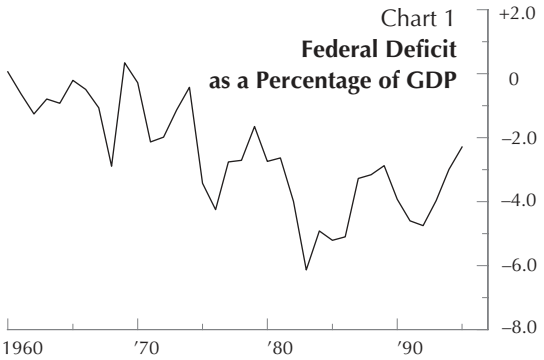
The Deficit and Total Outlays Recently Have Decreased...

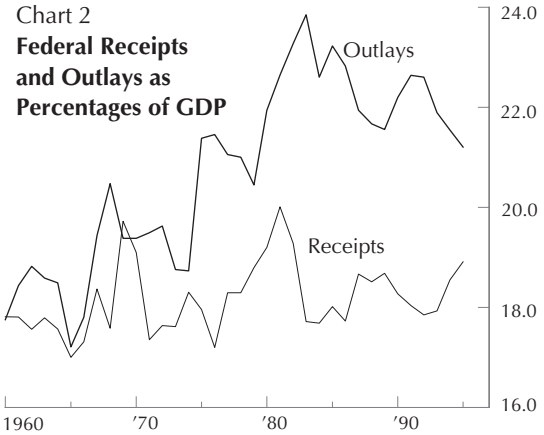
The budget deficit already is substantially lower than it was a few years ago. It decreased from $290 billion in FY 1992 to $164 billion in FY 1995. More important, the deficit shrank to 2.3 percent of Gross Domestic Product (GDP) last year, its lowest percentage in 16 years (see Chart 1). Reduced outlays and increased receipts, in relation to GDP, contributed to this deficit reduction. At 21.1 percent of GDP in 1995, Federal outlays were the lowest since 1979. Federal receipts increased to 18.9 percent of GDP, the highest since 1982 (see Chart 2).

These trends largely reflect the rebound in the economy since 1992, the sharp decrease in defense spending following the end of the cold war, and the winding down of the costly Federal bailout of the savings and loan industry. The difficulty for policymakers is that these factors will not have as big an impact on deficit reduction in the future. In particular, the "peace dividend" has about run its course. Defense spending decreased to 4.2 percent of GDP in 1994, the lowest proportion since 1948.

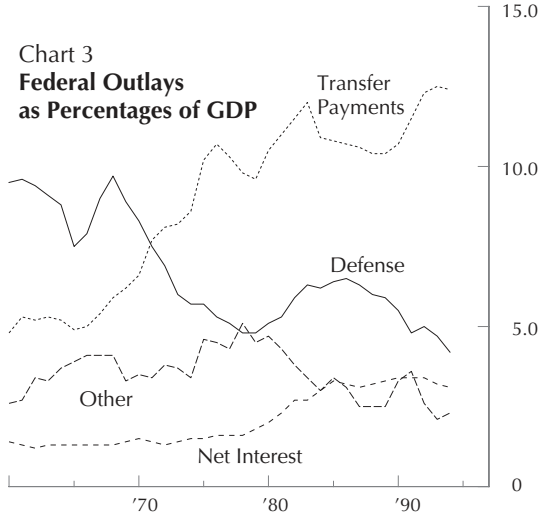
...But The Biggest Programs Continue to Expand

Chart 3 shows Federal outlays broken down by function. As the chart shows, the bulk of Federal outlays are for transfer payments, which are payments that are made by the Government to individuals or other entities, including state and local governments, for which no goods or services are provided in return. These payments include Social Security, Medicare, Medicaid, government and military pensions, unemployment benefits, and food stamps. Since the 1960s, transfer payments have increased far more rapidly than GDP. By 1994 they equalled 12.4 percent of GDP. They now account for roughly 56 cents of every dollar spent by the Government.





Source for Charts 1 and 2: *Office of Management and Budget, Treasury Dept., Commerce Dept.*



Source: *Budget of the United States Government, Fiscal Year 1996*, Table 6.1.

Most of this spending is "mandatory," *i.e.*, the amount spent depends on program eligibility and benefit rules set by Congress rather than on direct appropriations. Mandatory spending for these entitlements, and for interest payments on the national debt, accounts for two-thirds of total Federal spending.

Achieving lasting limits in government spending and a long-term balanced budget cannot be achieved without reining in

these programs. Over the next seven years, the budget could be balanced by making moderate changes in them. This appears to be what both the Republicans and the White House were calling for in their budget plans.

For example, both plans called for increasing Medicare spending at a slower rate than projected under current Medicare law. Total Medicare outlays over the next 7 years were projected to be roughly 8 percent less (under the Republican plan) and 5 percent less (under the White House proposal) than the $1.82 trillion that the program is expected to cost if left unchanged. This would hardly "gut" Medicare. And neither plan proposed to change Social Security, the largest domestic entitlement program of all.

Beyond 2002, however, it will be impossible to maintain a balanced budget and limit Federal spending without making sweeping changes in Social Security and Medicare. In 2007, the first of the baby-boom generation will turn 62 and become eligible to collect early-retirement Social Security benefits. After that, the proportion of the population eligible for age-based entitlements will balloon and the ratio of workers to retirees is expected to decrease. While future economic conditions could be better than currently expected and ease the expected financing problems, these demographic trends promise to make the tax burden required to pay for these entitlements much more onerous than it already is.

An Opportunity

The next decade provides politicians with an opportunity to confront the entitlement problem by adopting transitional reforms rather than waiting until drastic, sudden changes become inevitable. In this respect, how projected savings are achieved is as important as the amount of the savings.

The payroll tax increases instituted by the 1983 Social Security Amendments are an example of one type of reform to avoid. They were presented as a means of partially "prefunding" future Social Security benefits and thereby lessening the burden on taxpayers in the next century. This was a misguided notion from the start, however, and the "IOUs" in the trust funds will not reduce future taxes one whit.

Unless benefits are curtailed, the payroll tax needed to pay them will have to increase markedly during the next century. At present, a large portion of workers pay more in Social Security taxes than they pay in income taxes, and payroll taxes are seen by many as a significant barrier to employment growth. Increasing the payroll tax could further erode the employment base on which it is levied -- more workers will work "off the books" or withdraw from the labor force entirely and employers will increasingly automate or provide less complete products and services to consumers. Highly-taxed labor inputs could be shifted to the untaxed efforts of consumers. "Some assembly required" could become "all assembly required," restaurants could serve buffet-style and require diners to bus their dishes, etc. An early manifestation of this may be seen at what used to be called service stations where consumers now pump their own gas and pay with a credit card at the pump, receiving no service at all.

Some analysts have concluded that the increasing proportion of retirees in the adult population combined with an increasingly punishing payroll taxes could eventually push the latter toward 40 percent or more if the benefits called for under current law are maintained and they remain financed with payroll taxes. Few believe this will happen, however, and it seems inevitable, that benefits will be substantially curtailed. Most likely, the curtailment will be less for those now receiving benefits (and for those close to retirement age) and greater for those with more time to prepare for their retirement. If so, then the issue of reducing the tax burden on private retirement savings will need attention. Younger workers, who will receive only a fraction of the benefits that their parents and grandparents received, will need more incentives and fewer barriers to save for their own retirement.

Savings in Medicare outlays could be achieved by moving closer to either a market-based system or a politically-based system for allocating scarce health-care resources. The present program has kept beneficiaries' costs artificially low and thereby tended to increase the demand for and the price of Medicare-covered services. Increasingly, access to such services is decided by bureaucrats and politically-connected individuals who decide who gets what care and what this care "should" cost. Market-based reforms would shift decisions about the most cost-effective course of treatment back to patients and physicians.

These and other issues will have to be confronted sooner or later, and soon is better than later because the transition can then be made less disruptive. Asserting that the "era of big government" can be brought to an acceptable end without reforming Medicare and Social Security is wishful thinking.❑

The State of the Union

In most prior years, we have deemed it worthwhile to comment at some length on the President's State of the Union address. This year we depart from custom, mainly because Mr. Clinton — apparently in an effort to direct his political fortunes through grand appeals to broadly bipartisan concerns — offered no specific proposals that warrant our analysis.

Rather, we note only the fundamental contradiction inherent in his two principal themes. That is, his remarkable assertion that "the era of big government is over" (if you believe this you will believe anything) simply cannot be reconciled with his view that America must not be permitted return to the time when people "had to fend for themselves."

In our view, a more coherent phrasing would suggest that the era of big government will be over only when people are *permitted* to fend for themselves — *i.e.*, to pursue their own interests unfettered by a government intent on "making a difference in people's lives." The underlying issue is the preservation of individual sovereignty, also termed human freedom. Ironically, it is perhaps the only issue on which this talkative President has remained completely silent.

PRICE OF GOLD

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